

CC BG



Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Peter Walker MBE MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
London SW1

NBM

10 March 1986

Dear Secretary of State

SELECT COMMITTEE ON ENERGY: REPORT ON GAS PRIVATISATION

You wrote to Nigel Lawson on 10 March enclosing a draft reply to the Energy Select Committee report on gas privatisation. I had only one significant comment, which my Office has spoken to yours about. This was that the section in the draft reply on competition (paragraphs 7-13) gives a rather gloomy picture of the potential for increases in gas sales in the future. Whilst I recognise that you want to emphasise to the Committee the competitive pressures that British Gas will be under, I think the draft response overdoes it. In order for a successful sale which reflects the true value of the company, we shall need to demonstrate that British Gas has scope for expansion and growth in profits. This will be difficult unless the passage concerned is recast in a more positive direction. I recognise the time constraints you are under, but I think it would be sensible to show this passage to your financial and PR advisers for their views before publication.

I am copying this letter to the Prime Minister and the Secretaries of State for Trade and Industry, Scotland and Wales and Sir Robert Armstrong.

Yours sincerely
Vinen Life

PP JOHN MOORE

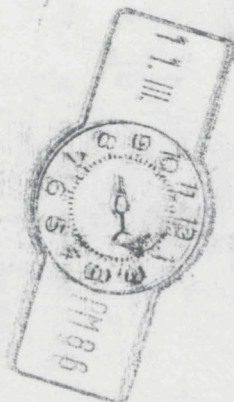
(Approved by the
Financial Secretary
and signed in his
absence)

2901

NAT IND

GRAS

PT 12



Lebb

01 211 6402

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

NBP

10 March 1986

SELECT COMMITTEE ON ENERGY: REPORT ON GAS PRIVATISATION

The Select Committee on Energy published a report on 21 January on our plans for regulation of the gas industry after privatisation. While endorsing the general thrust of our approach it made a number of detailed points on the proposals.

I propose to respond to the Report in a low-key, largely factual, memorandum to the Select Committee, a copy of which is attached. There is little if anything new or likely to attract much attention here. It describes our overall approach - reinforcing competition where this is possible and providing effective regulation where it is not - along the lines I outlined at Second Reading and in my appearance before the Committee. The memorandum describes our proposals in the Gas bill and the draft authorisation published in December and notes the inclusion in the Bill during Committee of a competition duty on the Director. It also covers our new policy on gas imports and exports.

The normal two month period for such responses will be up in the week of the Report Stage of the Bill scheduled for 17 March. It is important that we give the response before this, and I therefore intend to send it to the Committee on Tuesday 11 March and make it public shortly thereafter.

I am copying this letter and the Memorandum to the Prime Minister and the Secretaries of State for Trade and Industry, Scotland and Wales and Sir Robert Armstrong.

PETER WALKER

REGULATION OF THE GAS INDUSTRY

MEMORANDUM BY THE DEPARTMENT OF ENERGY IN REPLY TO THE ENERGY SELECT COMMITTEE REPORT

INDEX

| | | Paragraphs |
|------|---|------------|
| I | INTRODUCTION | 1 - 6 |
| II | COMPETITION | 7 - 13 |
| III | REGULATION | 14 - 21 |
| IV | THE REGULATORY STRUCTURE | 22 - 26 |
| V | THE OFFSHORE MARKET | 27 - 31 |
| VI | COMMON CARRIAGE | 32 - 37 |
| VII | THE PRICE REGULATION SYSTEM | 38 - 51 |
| VIII | ACCOUNTING POLICIES | 52 - 58 |
| IX | CONSUMER REPRESENTATION | 58 - 64 |
| X | ENERGY EFFICIENCY | 65 - 67 |
| XI | ROLE OF THE SECRETARY OF STATE AND OTHER MATTERS | 68 - 76 |

DRAFT

REGULATION OF THE GAS INDUSTRY - MEMORANDUM BY THE DEPARTMENT OF ENERGY

I INTRODUCTION

1. This Memorandum forms the Government's response to the First Report from the House of Commons Energy Committee, Session 1985-86 (HC 15).
2. The Committee's report was directed to the Government's proposals for regulating the privatised gas industry as set out in the Gas Bill and the draft Authorisation which will permit British Gas to operate as a public gas supplier. The reply explains the Government's approach to regulation and then addresses the Committee's observations and recommendations.

The Government's approach

3. The Government's proposals for regulating the privatised gas industry have been based on two guiding principles. Wherever possible, competition provides the best protection for customers and every opportunity has been taken to open avenues to market forces and reinforce competition. Where this is not possible, there needs to be strong and effective regulation to protect the consumer.
4. The Government has therefore taken a number of steps to reinforce competition between fuels and within the gas market:
 - the authorisation issued under the Bill will require British Gas to make clear the basis on which it prices gas to its industrial and commercial contract customers and to publish a schedule of maximum prices. This is an important step towards improved transparency in the industrial fuel market. Industrialists will be given better information about gas prices and will be better able to judge whether gas or some other fuel best suits their purpose;
 - the arrangements first set out in the Oil and Gas (Enterprise) Act 1982 governing direct supply from private suppliers to customers will continue. The Bill makes clear that the authorisations for such supplies will be subject only to safety related conditions. In

addition it will be open to newcomers to apply for authorisations as public gas suppliers in areas not served by British Gas;

- the common carriage provisions introduced by the Oil and Gas (Enterprise) Act have been reinforced. British Gas will be obliged to publish guidance about common carriage terms, including examples of prices, to assist potential users and to ensure greater transparency for competition within the gas supply market. British Gas will also be obliged to provide back-up supplies of gas to third parties for whom it is carrying gas to enable the third parties to achieve greater security of supply. This facility has particular relevance for customers for whom continuity of supply is important and who may be considering contracting with an independent supplier. In addition British Gas will provide an explicit assurance that it will not discriminate against offers of residual gas from producers who have sold gas from their fields in common carriage deals;
- there will be new freedoms in the offshore gas market. After privatisation British Gas will be able to import gas, and gas producers will be able to apply for waivers of the landing requirement. The Government will continue to ensure that the wider national interest is protected, in particular in relation to continuing security of supply.

5. In other areas the Government has set up a strong and effective regulatory regime:

- there will be a new Office for Gas Supply (OFGAS) headed by a Director-General, to monitor and control the activities of the industry within the framework set out in the Bill and Authorisation;
- the Director of OFGAS will be backed up by a new Gas Consumers' Council (GCC) to advise him on matters concerning consumers and to investigate complaints;
- the Director will have wide ranging powers to enforce the obligations laid down in the Bill and Authorisation, and to take steps to modify the regime to meet new circumstances. He will be fully equipped with information and other powers for these tasks;

- the authorisation provides a range of controls over British Gas's activities in the tariff sector, including a price control formula which will set incentives for increased efficiency and ensure that benefits are shared with customers. The authorisation will require preparation and publication of proper accounts for the gas supply business to ensure full transparency of the activity;
- the Bill provides proper recourse for any complaints in the contract market. These can be pursued through the GCC and if abuses occur, it will be open to the Office of Fair Trading to take action. If necessary, formal regulation could be extended into the contract market within the framework of the authorisation.

6. These proposals provide a comprehensive framework for regulating the industry after privatisation and strike the right balance between competition and regulation. They build on the experience of more than a hundred years of private sector gas in the UK prior to nationalisation, and on experience of regulation abroad. The proposals will provide a firm basis for the gas industry to maintain and improve on an efficient and effective gas supply service to gas consumers in Great Britain, and for British Gas to flourish in the private sector for the benefit of customers employees, shareholders and the nation.

II COMPETITION

7. The Government believes it is important not to regard the gas supply business in isolation, but to view it in the context of the overall energy market in which it has to compete. The need to compete successfully within the energy market acts as a real curb on any potential monopoly abuse by the gas supply industry. As the Select Committee recognised there is a spectrum of competitive pressures which act on the gas supply business dependent on the alternative fuels available to particular consumers, the relative prices of those fuels and the investment associated with switching at any given time.

Domestic sector

8. There is strong competition in the domestic market between gas and electricity for cooking and space heating as might be inferred from the resources both industries devote to advertising. While the Committee rightly point to the financial commitment which investment in heating systems and appliances

represents for many individual consumers, a large number of decisions is taken each year to invest in new heating systems or appliances either for the first time, or as replacements. The numbers of people so doing are not insignificant. About 1m decisions are made each year on central heating boilers and in 1984/5 1.2 million households bought an electric or gas spaceheater. At present gas has a 60% (1984/1985) share of the domestic energy market, but has been facing considerable competition from electricity. In the cooker market the introduction of new electric appliances such as microwave ovens has led to reduced use of existing gas cookers and electric storage heaters present real competition to gas central heating systems. But in turn this competition has stimulated the development of more sophisticated gas cookers and more efficient gas central heating systems. In the new housing market, gas faces intensive competition from electricity in today's smaller more highly insulated dwellings. Gas has higher installation costs than electricity, which can make it less attractive to builders, and gas's running cost advantage is reduced in low consumption buildings.

Commercial market

9. Gas, oil and electricity each have about 30% of the commercial market and coal's share is just under 10%. Coal has gained in competitiveness for larger central heating needs, for example in the health and education sectors, but the main competition continues to be from oil and electricity. At today's oil prices, competition with gas oil is becoming keener, and if prices stabilise at present levels gas could fail to gain potential customers who were considering conversion from oil to gas. Lower costs and ease of installation make electricity generally attractive in small premises. In larger store premises with significant cooling requirements, combined electric heating and chilling units can be cheaper than separate gas central heating and electric cooling systems.

Industrial Market

10. Gas has a 35% share of the market, compared to 20% for coal, 16% for electricity, 9% for heavy fuel oil and 14% for gas oil. Coal has made inroads into the interruptible gas market as technical advances improve the convenience and competitiveness of coal burn. Since 1981 gas has lost, or can expect to lose contracts totalling some 320m/therms a year of sales as a result of decisions by firms to invest in coal burning equipment. This represents some 8% of the interruptible gas market. Conversely gas has taken market share from oil. The

competition between gas and heavy fuel oil (h.f.o.) is especially keen since most interruptible gas customers have facilities for burning both and can respond quickly to price changes. The impact of lower oil product prices is already evident in prices being negotiated for interruptible gas.

11. In the firm gas market the main competition is with gas oil whose price is similarly declining and with electricity, particularly in the specialist industrial process sector.

12. There is active competition throughout the market and the recent falls in oil prices can be expected to give it new impetus and lead to more vigorous sales efforts by all the fuels. The Committee recognises that there is "much evidence of substantial aggregate fuel switches over time". The rapid conversion of industrial equipment from coal to oil in the 1960s and in more recent years to gas burn are only the more notable examples of the market at work and the Government doubts that the Committee has given sufficient weight to the number of investment decisions taken each year. The reality is that each fuel supplier has a commercial interest in pricing to retain customer good will and commercial interest is underpinned by competition law which already contains wide ranging provisions to check anti-competitive practices and monopoly abuse in the energy market.

Competition within the gas market

13. The Oil and Gas (Enterprise) Act 1982 created new opportunities for competition within gas supply. These have a direct importance in that they enable large customers to turn to independent suppliers. They also have indirect importance in that their existence influences the terms on which gas is purchased from producers and sold to industry. The improvements which the Government is introducing to the common carriage regime are designed to reinforce these opportunities and their effect on the internal working of the gas market. In addition to independent supply from offshore fields there may be useful scope for onshore gas finds such as that at Hatfield Moors to offer direct competition to British Gas or supply areas which it does not serve.

III REGULATION

14. The Committee note (paragraph 15) it is generally accepted that supply of gas to small consumers (domestic, small commercial and small industrial users) is a

natural monopoly. It makes neither economic nor practical sense to lay two or more pipelines down each street to supply small premises.

15. The Government is introducing effective regulatory arrangements to protect these small consumers and to oversee gas prices and terms and conditions of supply. These arrangements will be applied to all consumers who take under 25,000 therms a year who will have specific rights of supply and must be charged on the basis of a published tariff. There is provision for the regulatory regime to be adjusted to take account of market developments, through modifications to the authorisation, and for the price control formula to be reviewed after an appropriate interval. The importance of gas's monopoly in supply to small consumers will vary with changing terms of competition between the fuels and account will need to be taken in any adjustments to the regime of the way the market develops.

16. Customers who take more than 25,000 therms a year negotiate individual contracts with British Gas, and industry has made it clear, in consultations with Government and in evidence to the Committee, that it wishes this to continue. The Government's proposals concentrate accordingly on promoting freer and more transparent competition in the industrial contract market. As a condition of the authorisation permitting the new company to act as a public gas supplier, British Gas will be required to publish a schedule of maximum prices payable for gas by contract customers, together with a general policy statement about its approach to price negotiations. In addition, the authorisation will require the company to publish general guidance for those wishing to arrange alternative common carriage supplies, including examples of prices chargeable for conveying this gas. These measures are designed to provide a more open market and to assist customers in conducting their negotiations for fuel supplies.

17. The contract market will be subject in the normal way to competition law and the legislation provides for complaints to be taken up by the Gas Consumers Council. The Company will also provide a statement about its intentions for contract market prices over the next three years and will make clear it will not set prices in such a way as to restrict, distort or prevent competition. The legislation provides, as a final safeguard, the possibility of including the contract market within the overall framework of control under the authorisation.

18. The gas appliance market is not a natural or a statutory monopoly and the Government does not believe it would be right to subject it to the regulatory system designed for gas supply. There is intense and growing competition in the

retailing of both gas and electricity appliances and appliance retailing is itself only one aspect of competition between the fuels. There are now considerably more private sector outlets for gas appliances than British Gas showrooms. Gas appliance retailing, installation and servicing are already the responsibility of the Office of Fair Trading under existing competition legislation and action can be taken against British Gas or any other person active in the market for anti-competitive practices or monopoly abuse.

19. The Government considered carefully whether regulation of gas prices at the well-head was likely to assist the working of the gas market offshore or provide protection for consumers. Experience of regulating well-head gas prices elsewhere has demonstrated that price control can lead to serious long term distortion; in the U.S. artificially low well-head prices drastically reduced the level of gas exploration activity while greatly stimulating consumer demand. Competitive pressures from other fuels and the profit incentive will ensure that British Gas continues to have a strong incentive to buy its supplies cheaply. The present instability in the oil market demonstrates the extent to which the price of competing fuels may vary without notice, and the commercial risks to British Gas if it is unable to meet such a challenge by containing costs wherever appropriate. Bureaucratic intervention to secure what, in effect, would be an administered gas price would not assist this process. There will however remain an important continuing role for Government in ensuring that momentum is maintained in the UKCS and that national interest considerations such as security of supply are safeguarded.

20. The Government shares the Committee's concern to promote competition wherever possible but does not believe that this will be achieved by giving the Director of OFGAS a duty to promote competition in all areas where British Gas conducts, or may in future conduct, activities (paragraph 69). The Government has, however, accepted an amendment to the Bill which will lay a duty on the regulator to enable persons to compete effectively in the supply of gas to industry and large commercial customers (those taking over 25,000 therms a year.)

21. The Committee also recommend that private suppliers wishing to supply up to 2 million therms a year to individual consumers should not have to apply for authorisations. As mentioned above in paragraph 4, such authorisations will be subject only to safety related conditions. The legislation ensures that wherever private suppliers can safely be authorised they will be; the authorisation procedure will not represent as a constraint on competition.

IV THE REGULATORY STRUCTURE

22. Regulation of the gas industry will be the responsibility of the Director of OFGAS who must ensure that gas suppliers comply with the requirements laid down in statute and in their authorisations. Where the Director believes that the conditions of an authorisation are inappropriate or inadequate in any respect, he may seek the suppliers' agreement to a modification. If this is not forthcoming the matters can be referred to the Monopolies Commission. Where the Commission concludes that modifications should be made, they will be added to the authorisation.

23. The Director will have power to make references to the Monopolies Commission on all matters affecting tariff consumers. Matters affecting industrial and other contract customers will fall to the Director-General for Fair Trading (DGFT), who has the necessary powers and expertise to address the industrial energy market as a whole and to investigate anti-competitive practice or other abuse by gas or its competitors at any point in the market.

24. It will be similarly open to the DGFT to make reference to the Monopolies Commission. The Government is strengthening the existing provisions of competition legislation as they affect the public gas suppliers, and is providing for suppliers' authorisations to be modified by the Secretary of State, where he considers this appropriate, on this basis of recommendations from the Monopolies Commission. Such modification could extend existing gas-specific regulation into the contract market.

25. The Office of Fair Trading is also the appropriate body to deal with wider aspects of inter-fuel competition and it would not be right to charge the Director of OFGAS, as the Committee suggest, with responsibility ranging across the energy market (paragraphs 58, 76, 77, 81). Nor does the Government see a need to set up a separate Gas Commission to take on the role already envisaged for the Monopolies Commission (paragraph 83). The approach outlined at paragraphs 3-6 above calls for the active promotion of competition alongside suitable regulation of gas supply. OFT and the Monopolies Commission have an integral part to play in achieving this aim and their involvement is, in the Government's view, better calculated to improve the working of the market than regulation centred on gas.

26. The New Gas Consumers' Council will have an important role in the structure. In addition to advising OFGAS on tariff matters. The Council will be able to investigate complaints from both tariff and contract customers. In any

matter where it appears to the Council that it would be appropriate for OFGAS or OFT to exercise their statutory functions, the Council will be under a duty to refer the matter to the appropriate Director.

V THE OFFSHORE MARKET

27. In its Seventh Report, Session 1984/85 (HC 76-I), the Committee recommended that exports should be permitted when the ratio of gas reserves to production exceeded an appropriate security margin. The Committee argued that Government must retain an over-view of gas imports but that any qualifications to commercial freedom in the national interest should be publicly declared. In its First Report Session 1985/6 the Committee recommends that Government should remove all restrictions on both gas imports and exports (paragraph 53).

28. The Government has decided that a more open regime for gas imports and exports should now be introduced. British Gas will be able to import gas subject to the normal consent requirements for laying pipelines on the UK Continental Shelf and, where appropriate, the conclusion of inter-Governmental treaties. British Gas has given an explicit assurance that it will consult the Government on its import plans as these develop. On exports the Government will in future be prepared to consider, on a case by case basis, applications for waiver of the requirement to land gas in the UK. but in doing so, it will take into account security of supply considerations.

29. The Committee express concern that BGC might discriminate, in purchasing, in favour of its own fields and recommended that OFGAS should be charged with ensuring that discrimination does not occur. Competition legislation, and particularly the provisions of the Fair Trading Act 1973, already provides statutory protection against significant cases of preference or discrimination including the possibility of reference to the MMC. In addition, the Government, through the Department of Energy, obtains full information on the development status and potential of all UKCS fields and is well placed to ensure that projects are not set back by discriminatory behaviour. The Government does not believe that OFGAS could add importantly to existing protections or that it would be the appropriate body to undertake regulation offshore.

30. The Government notes the Committee's concern that some smaller oil companies fear take-over by British Gas. The Government wishes small independents to prosper since they have important contributions to make on the

UK Continental Shelf. The opportunities open to British Gas for interest acquisition will be the same as that which already exists for all other major companies in the UKCS.

31. The Government welcomes the Committee's support for Clause 61 in the Gas Bill which provides for the Secretary of State to issue directions to ensure that British Gas does not make unfair use of confidential information supplied during gas sales negotiations.

VI COMMON CARRIAGE

32. The Government has extended significantly the provisions of the Oil and Gas (Enterprise) Act for the carriage of gas for third parties through British Gas's supply network, enhancing the opportunities for competition in supply to larger customers.

33. If a prospective third party supplier is not satisfied that he has been offered reasonable terms for common carriage in negotiations with British Gas he may take the matter to the Director. The right of appeal is detailed, as the Committee recommend (paragraph 42), in Clause 19 of the Bill. This allows those who wish to use a public gas supplier's pipelines for delivery of gas to apply to the Director to determine whether pipeline capacity can be made available and on what terms it should be provided. The Director will be in a position to make a determination if normal commercial negotiations have failed to reach a satisfactory conclusion.

34. The Committee also recommend that the right of appeal permitting the Director to set the terms of the supply of back-up gas, should be clearly defined (paragraph 43). The Government accepts this and is considering the position.

35. A potential difficulty for a producer attempting to sell direct to customers is that he may not be able to place the whole of his field. Residual gas of this kind is already subject to the safeguards described at paragraph 29 above and as the Secretary of State explained to the Committee (Q.326 page 79) it would not be appropriate to impose an obligation on British Gas to make specific purchases. British Gas has, however, given an explicit undertaking that it will not discriminate against offers of residual gas from fields where gas is sold to common carriage users.

36. The Committee suggest that for a "transitional period" the Director should have the right to require British Gas to charge for common carriage in existing pipelines on a basis reflecting short run marginal costs (paragraph 47). The principles laid down in clause 19 of the Bill require the Director to set charges giving third parties access to British Gas's pipeline system on the same terms as British Gas itself. This will ensure that independent users of British Gas's supply system are treated on a basis of equality with British Gas, and the Government believes this is the right approach. Clause 19 does not preclude marginal cost charging, provided this is the basis of charge being applied generally for the supply system.

37. The Committee invited the Government to consider whether an obligation should be placed on British Gas to guarantee supplies to customers whose alternative supplies had been terminated (paragraph 48). It will be open to such customers to approach British Gas for a supply in the normal way. Public gas suppliers are generally obliged under clause 9 of Bill to meet any reasonable demand for gas where it is economical to do so. An unreasonable refusal to supply would be a matter for the Director of OFGAS who can enforce the supply obligation.

VII THE PRICE REGULATION SYSTEM

38. The Government welcomes the Committee's recognition (paragraph 25) of the advantages of price rather than profit control.

39. As it has previously stated, the Government believes that the price control formula set out in Condition 3 of the draft Authorisation will provide real protection for tariff customers, both in respect of the price for gas and the standing charge. Through the X-factor it will also ensure that British Gas has a continuing incentive to achieve real reductions in the costs under its control. It also ensures that costs genuinely outside the Corporation's control may be reasonably reflected in charges to customers.

40. In its detailed examination of the formula, the Committee proposed that the Director be given the right to refuse any tariff increase in circumstances where the actual price already charged had exceeded allowable thresholds. This is already provided for.

41. If in any one year British Gas has overshot the Maximum Price by more than 4% it has to provide an explanation to the Director, and may not increase prices

in the next year unless it can demonstrate to the satisfaction of the Director that it would not be likely to overshoot the maximum again. Should the cumulative excess over two years amount to more than 5%, then the Director may step in to determine the price (such that in his judgement it would not exceed the maximum in the next year). The Condition therefore already produces the effect the Committee was seeking, and provides powerful and effective safeguards for consumers.

42. In paragraph 35, the Committee also asked for an explanation of the principles which will be adopted for deciding how Condition 3 will be replaced after it lapses.

43. The Government believes that a decision about the possible continuation of price control after the initial five year period must properly be addressed in the circumstances prevailing at the time. In technical terms, when the Condition lapses, it will require a modification of the authorisation to continue the formula, or to continue price control in a revised form. The procedures for modification are set out in the Gas Bill. Clause 23 provides for modifications to be made by agreement between Director and British Gas. Alternatively, the Director may make a reference under Clause 24 to the Monopolies and Mergers Commission. Clause 26 provides for modifications to be made following a report by the MMC.

44. In assessing how or whether price control should be modified or reset, the Director will be guided by his duties set out in Clause 4. In any reference to the MMC, the Commission must similarly have regard to the duties in Clause 4. These provide the appropriate framework against which the future of price control must be judged. In addition, the Director will have full powers to call for any information he believes may be necessary for his consideration of what should replace Condition 3 after it lapses.

45. In paragraph 29, the Committee sought examples of the operation of the formula based on different forecasting scenarios. Future trends will reflect factors as diverse as the rate of inflation, exchange movements and oil prices which cannot be forecast with any accuracy. However, the Government confirms that the illustrative figures in the Appendix to the Committee's report correctly show how the formula would operate in the particular circumstances chosen (provided that table 5 is taken to be based on the inflation assumptions set out in table 6).

The Y Factor

46. The Committee recommended (paragraph 37) that Condition 3 of the draft Authorisation be amended to require the Director to satisfy himself that the Allowable Gas Cost was prudently incurred to meet the requirements of regulated tariff customers, and that he should have the power to disallow any costs not so incurred.

47. As noted in paragraph 19 above, British Gas has a strong incentive to buy its supplies cheaply. Signing up long term contracts at unnecessarily high prices would be damaging for the company. It would jeopardise long term competitiveness, and since about 40% of gas is sold in the contract market costs have to be met from contract sales, profitability of supply to that sector would be put at risk. Moreover 90% of the gas for the period up to 1992, has already been contracted or will be produced by British Gas. The Government does not accept that the Director has a role here.

48. In paragraph 37 the Committee expressed the view that "if expensive gas is purchased to satisfy demand outside the regulated market, the full marginal cost should be recovered within that quasi-competitive market".

49. The effect of the price control formula in Condition 3 is to relate changes in the maximum average price to changes in the actual cost of gas. The Government believes this a fair and straight-forward way of controlling changes in price in the tariff sector. The suggestion that particular tranches of gas should be reserved to particular customers or classes of customer, and that some but not others should meet the full marginal cost of new supplies could not be accommodated in a practical regulatory mechanism. Nor would it be fair.

Standing Charges

50. The Committee asked for assurance (paragraph 38) that in calculating the revenue per therm for the purpose of establishing whether the price formula has been adhered to, standing charges will be taken into account. The Committee also asked for consideration to be given to whether any rewording of the draft Authorisation was necessary to make the point indisputable.

51. The Government confirms that standing charges are within the overall control of the price formula. The average price controlled by the formula is the Tariff Revenue in the year divided by the Tariff Quantity supplied. The

definition of Tariff Revenue set out on page 13 of the draft Authorisation explicitly includes standing charges.

VIII ACCOUNTING POLICIES

52. Condition 2 of the draft Authorisation requires British Gas to draw up accounts for the gas supply business as a whole, and gives a clear role to the Director in scrutinising the allocation of cost between the gas supply business and any other business British Gas undertakes. The purpose is to ensure British Gas draws up proper accounts which represent a true and fair view of the profitability and financial position of the gas supply business.

53. From the start, the Director will be able to use his powers to call for all necessary information covering the tariff market and he will therefore have access to information about the possible bases on which costs and revenue can be related to the tariff market. The Director also has discretion to publish information he considers appropriate. Against this background, the Government has considered the Committee's recommendation (paragraph 33) that Condition 2 of the draft Authorisation be amended to require British Gas to publish the profits that arise from tariff sales, and that the Director should certify the figures to be a fair reflection of revenues and costs ascribable to the market.

54. Any requirement to publish detailed profit figures must be compatible with the nature of the business. The nature of the integrated gas supply business means that it is not possible to associate in a rigorous way specific costs to individual sectors of the market. The objective accuracy of separate profit figures for tariff and contract sectors is not sufficient for regulation to require audited published accounts. The same problems of shared costs arise within the gas supply business in disaggregating costs and profits between different regional activities (Committee recommendation in paragraph 72).

55. The Committee also recommended (paragraph 58) that the Director should have full and open access to the accounts of British Gas, and in particular to ascertain what judgements have been made in the apportionment of costs between the regulated and unregulated markets. The Government accepts the importance of this, and the provisions of Condition 7 of the draft Authorisation have been framed such that the Director is able to call for any information which may be necessary for him to carry out his functions. This would include information on apportionment of costs in addition to that provided regularly under Condition 2.

56. In paragraph 74 the Committee recommended that the Director be given a power analogous to that presently held by the Secretary of State to give directions as to the information required to be given in the annual accounts of public gas suppliers, over and above the minimum legal requirements of the Companies Act.

57. The Government agrees with the Committee's view that the Director should be able to publicise information. There is therefore specific provision in the Bill - Clauses 34 and 38 - to enable him to publish appropriate information, advice and reports. A power to issue directions relating to information in the Companies Act accounts is in these circumstances unnecessary.

IX CONSUMER REPRESENTATION

58. The privatisation proposals provide comprehensive protection to gas consumers' interests and represent an advance on the present position. The new Gas Consumers' Council (GCC) which will act as the consumers' voice has been given new powers compared to the current National and Regional Councils; it will be able to require information from British Gas on complaints concerning gas supply to both domestic and industrial consumers, and will be able to refer such complaints to the OFGAS Director or the DGFT as appropriate for possible action. It will therefore be properly equipped to carry out the tasks.

59. Ministers have made clear that the GCC will not be restricted to complaints on gas supply only. As is the practice with the current Councils, it is the Government's intention that the GCC should be able to consider representations from gas consumers on all gas-related matters concerning gas appliance sales and safety, installation and service. The Government recognises the concern of the National and Regional Gas Consumers Councils and the Committee that the legislation should cover explicitly the GCC's functions outside the area of gas supply (paragraph 60) and in the Standing Committee undertook to introduce appropriate amendments to the Bill at the House of Common's report stage, to clarify the scope of the GCC's remit.

60. The Committee also notes the NGCC's concern that the level of funding proposed for the new GCC is inadequate. As Ministers have explained in Standing Committee (21 January p.166) the figures set down in the Financial Memorandum are an initial estimate. It is the Government's intention that the GCC will be provided with the resources it needs to carry out its tasks effectively. The

necessary funding will be provided by British Gas and any other public gas suppliers though a fee required to be paid under authorisations on an annual basis.

61. The Government agrees with the Committee that it is important that the regional network of the GCC should be effective (paragraph 62) but that it should also be efficient. Ministers have also explained in Standing Committee that while the Government considers it inappropriate to enshrine rigidly in primary legislation a specific local organisation for the GCC based on British Gas's regional structure, there will be a member of the Council appointed to represent each of the twelve British Gas regions. Employees of the Council working with these representatives will staff offices in the regions, so that complaints can be taken up at a local level to ensure that the new Council keeps in close touch with consumers' views and needs.

62. The Committee suggests that gas suppliers should be obliged to distribute publicity for the GCC with their bills (paragraph 62). This is not a requirement laid upon British Gas at present, although British Gas does voluntarily publicise the current Gas Consumers Councils in their billing material. The Government considers it should be for the Council itself to decide how best to publicise its activities.

63. The Committee comments on Condition 12 of the authorisation dealing with the Codes of Practice on gas supply service and payment of bills (paragraph 61). It would not be appropriate to subject any breach of the Codes to an enforcement order by the Director. Those services which the Government believes British Gas should be required to provide are set out in the Bill, in particular, in the "public gas supply code", schedule 5, and in the authorisation (e.g. obligations to supply, free emergency service). The Director should not be expected to lay down in detail what services British Gas should offer beyond these statutory obligations. It is important however that both the Director and customers should be aware of the services they can expect of British Gas. British Gas is therefore required to publish Codes of Practice and to consider representations made by the Director and the GCC on their operation. The Government considers it right that the obligation to publish should fall on the supplier, although the Director is free under clause 34 of the Bill to publish information and advice for tariff consumers if he thinks it would be helpful.

64. The Committee also recommends that the Director should require British Gas to develop a set of performance objectives against which to measure standards of

service (paragraph 75). Again, the Government does not believe this is appropriate within the regulatory framework proposed. The fundamental responsibility for maintaining standards of service must be with the supplier who manages the gas supply business. British Gas fully recognises its obligations to its customers in this area and has stated publicly that care for the consumer is fundamental to the future success of its business. The GCC will be able to monitor standards of service on the basis of the representations it receives from consumers, and to advise the Director of any shortcomings in gas supply services to tariff customers. If any action appeared to the Director to be necessary he could as outlined above (paragraph 22) propose modifications to the authorisation to maintain standards and, if British Gas did not agree, refer the matter to the Monopolies Commission.

X ENERGY EFFICIENCY

65. The Select Committee refer to their two recent Reports, on the Energy Efficiency Office and on the Development and Depletion of the United Kingdom's Gas Resources. The Government has already given the Committee its observations on these Reports and would refer the Committee to the parts of those responses which are relevant to the Recommendations made in those Reports (paragraphs 28-31 of the Response on Gas Depletion; paragraphs 64-66 of the Response on the Energy Efficiency Office).

66. The Government believes that the imposition on the energy supply industries of a statutory duty to help all consumers improve their energy efficiency, and to submit an annual report on energy efficiency for approval by the Secretary of State for Energy (paragraph 67), would add little to the industries' already extensive energy efficiency activities.

67. A major aim of privatisation is to release industry from interference by Whitehall and generally to remove public sector restrictions on finance and on managerial initiative. In returning British Gas to the private sector, the Government would not want to impose upon it unnecessary statutory obligations which go beyond those that apply to normal Companies' Act companies. The Gas Bill places upon the Director a duty to carry out his functions in such a way as to promote the efficient use of gas. The Government believes it is right to provide this kind of broad guidance for the Director, and for the Director and the industry to work out how best to achieve the objective, without creating any unnecessary bureaucratic systems of reporting or control.

XI ROLE OF THE SECRETARY OF STATE AND OTHER MATTERS

68. Commenting on the role of the Secretary of State in regulation the Committee recommended that the Secretary of State should be obliged to seek the advice of the Director on any matter affecting the operation of the gas market, and that the Director should report to Parliament actions by the Secretary of State which he believed affected his duty to promote competition (paragraph 88). In the specific case of issuing authorisations for public gas suppliers under the Bill the Secretary of State is obliged to consult the Director. In addition the Director is required under clause 33 of the Bill to advise the Secretary of State either upon request or where he considers it expedient to do so. The Secretary of State, will, of course, be able to consult the Director, when he wishes to, on other matters, and the Government does not consider it appropriate to define further the relationship between the Secretary of State and the Director. The Director is already required to report annually on his own activities, and developments on matters which fall within the scope of his functions. Any significant actions by the Secretary of State would be included in this annual report, which the Secretary of State is required to lay before Parliament. The Committee's recommendation is therefore already fulfilled.

69. The Committee also recommended that any directions made by the Secretary of State under Clause 33 of the Bill should be laid before Parliament (paragraph 87). The Secretary of State explained in his evidence to the Committee (p 83 Qu 351) that the Bill only permits directions of a general nature on the considerations which the Director should take into account in ordering his or her priorities or to which the Director should have particular regard. The Government agrees with the Committee that any such directions should be notified to Parliament, and has accepted an amendment to the Bill so that any directions given by the Secretary of State are to be included by the Director in his annual report.

70. The Committee also suggested that it was excessive for the Secretary of State (who in this case will be the Secretary of State for Trade and Industry, since he is the Minister responsible for consumers affairs) to vet the appointments of principal officers of the Gas Consumers' Council (paragraph 87). The Bill in fact only requires that the Secretary of State be consulted on the appointment of the most senior officer. This officer will have executive responsibility for the staff employed by the GCC and be Accounting Officer for the Council. The consultation will allow the Department of Trade and Industry

which has experience of many consumer bodies to advise on whether prospective candidates have suitable qualifications and experience.

71. The Committee asked that the method of funding should guarantee the independence of OFGAS (paragraph 89). As the Secretary of State said in response to the Chairman's question (p 83 Qu 350), the Government agrees that OFGAS should be financially independent. As the Director will head an independent non-Ministerial Government department, its funding must be accountable to Parliament, and the presentation of a Vote is the most effective and appropriate means. The Director will be the Office's Accounting Officer, and will be responsible for ensuring that funds are sought each year sufficient to allow the Office to perform its duties, and that those funds are spent properly in pursuit of these duties. Expenditure will be covered by authorisation fees payable by British Gas and other suppliers. These fees are not a revenue raising device.

72. The Committee further expressed surprise that the privatisation of British Gas was likely to result in no more than a small reduction in Department of Energy staff numbers (paragraph 87). Setting aside the additional staff resources temporarily allocated to privatisation, Gas Division's complement should reduce substantially over the next two years. The remaining posts will be particularly concerned with upstream matters where the work load will continue. Reduction in staff numbers will be small in terms of the Department's overall complement (currently just over 1000), but significant in terms of the resources allocated to the gas industry.

73. The Committee recommended that the Government should consider in depth the merits of the US system of regulation adapted to the UK system and that the Government should also publish the material it has collected generally on foreign experience of regulation. In framing its proposals the Government has taken into account US practice as well as that of other countries. The Department's information on overseas experience has been gathered from a variety of sources including advice from H M posts; discussions with foreign experts, annual reports, journals, academic reports and other publications. The broad conclusions were submitted to the Select Committee as annex 2 of the Department's memorandum to the Committee of 30 October 1985. Because of the diversity of sources the information is not in a form which could readily be made available to the Select Committee. The Government will bear in mind the Committee's recommendation that

it should publish a White or Green Paper in advance of any further proposals for energy utility privatisation.

74. The Committee asked for reassurance on two matters not strictly related to "economic" regulation (paragraph 11):- rights of entry and competence of gas fitters.

75. The principle of rights of entry for private gas companies is well established; similar powers of entry to those in the Bill existed before nationalisation and some date back to legislation last century. In framing the privatisation proposals the Government has reviewed the rights of entry carefully, and they have been rationalised to remove any possible ambiguities. The rights of entry which remain are essential for public gas suppliers with statutory duties to supply gas. Entry without the occupier's consent can be effected only with the authority of a magistrate's warrant or in an emergency for safety reasons.

76. The Government recognises concern about installation of gas appliances and the Health and Safety Commission and Executive are drawing up a Code of Practice for gas installers in consultation with British Gas, the Confederation for the Registration of Gas Installers and others which will give practical guidance on training requirements and provide standards against which to assess competence. The draft code will be published in the Spring to allow for further consultation. The Government believes this is the right way forward at this stage.